No. 86-1772

Supreme Court, U.S.
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JOSEPH F. SPANIOL, JR.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

UNITED PACIFIC INSURANCE COMPANY
Petitioner

v.

LAUREL COUNTY, and LAUREL COUNTY FISCAL COURT
Respondents

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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JULY 2, 1987

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QUESTION PRESENTED

Whether construction project owners are liable to the general contractor's surety for progress payments which have been seized by IRS levy.

STATEMENT UNDER RULE 28.1

A list of parties has been provided by United Pacific in its Petition, and by Laurel County and Laurel County Fiscal Court in their Cross-Petition in Case No. 86-1922.

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STATUTES INVOLVED

In addition to the statutes cited by United Pacific in its Petition, and by these Respondents in their Cross-Petition, this case involves the construction and application of 26 USC §6331. The text of the relevant portion of that statute is reproduced in the Appendix.

CITATIONS

Dederman v. Jenkins, 111 F.Supp. 604 (N.D. Ga., 1953) 5
DeEdwardo v. First National Bank of Bath, 442 F.Supp. 499 (E.D. Pa., 1977) 6
Pearlman v. Reliance Insurance Company, 371 U.S. 132 (1962) 3
United Pacific Insurance Company v. United States, 320 F.Supp 450 (D.C. Ore, 1970) 5
United States v. National Bank of Commerce, 472 U.S. 713, 105 S.Ct. 2919, 84 L.Ed. 2d 565 (1985) . 6
26 U.S.C. §6331 6
26 U.S.C. §6343 ..... 2, 4, 5, 7, 8
26 U.S.C. §6532 8
26 U.S.C. §7426 ..... 2, 4, 5, 7, 8

COUNTERSTATEMENT OF THE CASE

On February 4 and March 11, 1970, the IRS filed tax liens against Y & S Construction Company, Inc., the contractor on the Laurel County High School Construction project, for unpaid withholding taxes for the third and forth quarter of 1969. On March 31, the contractor submitted application for a monthly progress payment, for work completed on the project. The architect certified such payment on April 17, and the certificate was forwarded to the Laurel County Board of Education for the issuance of the check by the County Treasurer.

On May 18, 1970, the IRS revenue officer served the County Treasurer with a tax levy on all property or rights to property of Y & S Construction Company, Inc. held by the project owners. The revenue officer had visited the Treasurer, Mr. Cloyd, several days earlier with a previous levy, and was put off by Mr. Cloyd until he obtained legal advice. On May 18, a check was issued to the IRS for $100,833.91 against the Y & S Construction Company project account and given to the revenue officer. The same day, the County Treasurer sent notice to United Pacific of the amount paid to the Internal Revenue Service pursuant to the levy. The surety was thus given notice on the day of payment that contract funds in which it claimed an interest, had been transferred to the IRS by the honoring of the levy.

Although the surety objected to the project owners of such payment, the surety apparently did not seek to recover such funds from the IRS, either administratively under 26 U.S.C. §6343, or by filing suit pursuant to 26 U.S.C. §7426.

After the Sixth Circuit's Opinion remanding to the Trial Court for further proceedings, Mr. Cloyd's deposition was taken as evidence on February 24, 1987. There was also tendered to the Trial Court by Affidavit, a copy of the check making payment to the IRS from the construction funds for the amount in question and showing that payment was made pursuant to IRS levy. Mr. Cloyd made clear in his testimony that he knew the difference between the tax lien documents filed in the County Clerk's Office, and the IRS levy served upon him by the revenue officer.

On remand from the Sixth Circuit, Laurel County and its Fiscal Court have moved the Trial Court for Summary Judgment based upon the deposition of Mr. Cloyd and the Affidavit and check. United Pacific has responded to the motion and the matter stands submitted before the District Court.

REASONS FOR DENYING THE WRIT

1. THERE IS NO BASIS FOR GRANTING THE PETITION SINCE THE SIXTH CIRCUIT'S OPINION DOES NOT AFFECT THE DOCTRINE OF EQUITABLE SUBROGATION.

The basis of United Pacific's argument rests on *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962). However, the Sixth Circuit's opinion does not conflict with the principles in *Pearlman*, and the opinion is in harmony with the doctrine of equitable subrogation. This Court in *Pearlman* declared that a surety, having paid laborers and materialmen, was entitled to be subrogated to their rights against the contract retainage to the extent necessary for its reimbursement. That doctrine is not disputed in the present case. The Sixth Circuit merely held that the surety had no claim against the project owners for breach of contract, where the owners honored an IRS levy. That holding did not diminish the surety's rights. The Sixth Circuit recognized that any claim the surety had against the owners was not because of their status as owners, but because of their custodial possession of the progress payment. When those funds were seized by the IRS, the surety's claim against the project owners was extinguised, and transferred to the new custodian, the IRS. Because funds in the hands of the IRS are governed by federal statute, the surety was obliged to comply with the statute to keep its claim alive. This the surety did not do.

The rights claimed by United Pacific as surety, under the doctrine of subrogation, are not self-enabling. To perfect its claim the surety must take some positive step to preserve and defend its claim. After the seizure by the IRS, the immediate notice given by the County Treasurer to the surety (see

Appendix) was sufficient warning to advise it of the IRS's competing claim to the funds. The tax code provided remedies to the surety in Sections 6343 and 7426. By taking no action until the statute of limitations expired, the surety slept on its rights, and failed to guard and sustain its claim in the property.

2. THE SURETY SEEKS EQUITY WITHOUT HAVING DONE EQUITY.

The surety seeks to divert this Court's attention from the issues disputed in the case. The Sixth Circuit did not address issues of equitable subrogation since such questions were not involved or challenged. Its opinion did not affect this surety's subrogation rights.

Subrogation is an equitable remedy. United Pacific suggests, on Page 8 of its Petition, that "subrogation" is synonymous with "equitable lien." In order for a party to invoke the equitable powers of the Court, it must first do equity. A recognized principle is that, "Equity aids the vigilant, and not one who has slept on his rights." The doctrine imposes upon a surety the duty to take all reasonable steps to mitigate his own damages, and not to exacerbate them. United Pacific, possessed with a claim against the monthly draw, failed to take steps to perfect that claim. When the County Treasurer advised the surety that the funds have been seized by the IRS, the surety took no action and allowed its claim against the funds to expire.

Sections 7426 and 6343 of the tax code were the methods available to the surety for perfecting its interest in the funds. United Pacific cannot claim ignorance of those methods, since it was involved in a

§7426 action itself in *United Pacific Insurance Company v. United States,* 320 F. Supp. 450 (D.C. Ore, 1970) at the same time as this case. If the surety had taken steps to perfect its claim under either section of the tax code, there would have been no need for this present action, and the adverse claims between the surety and the IRS would have been resolved years ago without the involvement of Laurel County and its Fiscal Court. The surety seeks the equity of subrogation, but has not accomplished the equity of mitigation.

3. AN IRS LEVY DOES NOT DETERMINE PROPERTY RIGHTS SO THAT A CUSTODIAN IS NOT LIABLE IN CONVERSION.

The foundation of the Sixth Circuit's opinion is its holding that,

> A payment made by a custodian of property in which the taxpayer has an interest pursuant to an IRS administrative levy is a valid defense to a subsequent action by a third party claiming an interest in the property.

In *Dederman v. Jenkins,* 111 F.Supp 604 (N.D. Ga., 1953), the Court found the holder of funds not liable to the true owner in conversion when the holder paid the funds to the IRS pursuant to levy with knowledge of the owner's claim. The Court reasoned that the stakeholder was not required to determine the true owner of the funds before honoring the levy. A bank, holding funds of the taxpayer in *DeEdwardo v. First*

National Bank of Bath, 442 F.Supp. 499 (E.D. Pa., 1977), was not liable in conversion for paying an IRS levy. The Court held that the honoring of the tax levy was a complete defense to the claim brought by a third party claiming true ownership to the funds.

This Court in *United States v. National Bank of Commerce,* 472 U.S. 713, 105 S.Ct. 2919, 84 L.Ed. 2d 565 (1985), observed that,

> The levy does not determine whether the government's rights to the seized property are superior to those of other claimants., L.Ed. 2d at page 574.

The Courts recognized that the levy does not determine priority or decide property interests in the property which has been seized. The seizure pursuant to levy entitles the IRS to possession, but not necessarily to ownership. This Court stated further that,

> The administrative levy, as has been noted, is only a provisional remedy. 'The Final Judgment in [a levy] action settles no rights in the property subject to seizure.', id, page 578.

The IRS' power to seize property pursuant to a tax levy is derived from 26 U.S.C. §6331. This Court stated explicitly that the tax levy,

> Is a provisional remedy, which does not determine the rights of third parties until after the levy is made, in post-seizure administrative or judicial hearings., id, page 581.

This Court suggested in *National Bank of Commerce* that a suit such as this one, is not proper. One

honoring a lawful levy is discharged by making payment pursuant to the levy, from liability to a third party claiming an interest in the property.

> Nor would the Bank be exposed to double liability were it to honor the IRS levy. The code provides administrative and judicial remedies for co-depositors against the government, and any attempt to secure payment in this situation from the Bank itself would be contrary to the federal enforcement scheme. id, page 579.

The administrative remedies available in Section 6343, and the judicial remedies in Section 7426 were not invoked by United Pacific.

In Footnote 13, Justice Blackman suggests that, "Any attempt to recover against the Bank under state law would be preempted." This case originated as such a suit. The Sixth Circuit followed Justice Blackman's reasoning by reversing that portion of the district court's judgment to the contrary.

4. THE TAX CODE PROVIDES SUFFICIENT REMEDY FOR ONE CLAIMING AN INTEREST IN FUNDS SEIZED BY LEVY.

Rather than abrogating the rights of the surety, the Sixth Circuit's opinion reaffirms those rights. An action instituted under Section 7426 must be brought by a person who claims an interest in the property wrongfully levied. The county agencies, as project owners, claimed no interest in the funds. By contract, monthly payments were not eligible for distribution

until and unless the architect certified that the work for which the payment was generated had been performed. The County, having received the benefit of the construction work, had no further claim on the monthly draw, and merely held funds for proper distribution to the contractor. Because of its subrogation rights, the surety qualified as a party "who claims an interest in or a lien on such property" under 7426. The county agencies on the other hand had no standing under either Section 6343 or 7426 to seek a return of the levied funds, since they claimed no interest in the funds. The nine month statute of limitations provided in 26 U.S.C. §6532 therefore applied to the surety, but not to the county agencies.

The very existence of 26 U.S.C. §6343 and §7426 presupposes that the IRS may not always enjoy an unrestricted or unencumbered claim to property seized by levy. The purpose of the levy is to promote the speedy collection of taxes to the government. In exchange for that right, Congress created procedures for third parties to protect their claimed interest in the seized property. That is the purpose of Sections 6343 and 7426. In this case, the surety failed to preserve its interest in the contract funds by either statutory method until the statute of limitations had expired.

Since the tax code provided avenues by which the surety could have protected its claim, a situation like the one in the present case will only arise when a surety sleeps on its rights or abandons its claim and later seeks redress from the funds custodian. Such problems will not occur unless a surety fails to pursue its claim. Presumably, such laxity is not as pervasive throughout the construction industry as it was by the surety in the present case.

CONCLUSION

The Petition for Writ of Certiroari should be denied. Since an IRS levy does not determine property rights, the surety's rights of equitable subrogation were not diminished by the Sixth Circuit's opinion. The Tax Code provided the surety with adequate means and methods of protecting its claim, and the project owners are not liable for the surety's failure to preserve its interest in the progress payment.

Respectufully submitted,

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CERTIFICATE OF SERVICE

The undersigned does hereby certify that three copies of this Brief in Opposition to Petition for Writ of Certiorari were served by mail to Hon. Bernard L. Balkin and Hon. Keith Witten, Sandler, Balkin, Hellman & Weinstein, P.C., 3130 Broadway, Third

Floor, Kansas City, Missouri 64111; Hon. William Gary Crabtree, 120 E. Fourth Street, P.O. Box 428, London, Kentucky 40741; Hon. Roger M. Olson, Assistant Attorney General, Department of Justice, Washington, D.C. 20530; Hon. Louis De Falaise, United States Attorney, Eastern District of Kentucky, Federal Building, Lexington, Kentucky 40507 and Hon. Charles Fried, Solicitor General, Department of Justice, Washington, D.C. 20530, on this 2nd day of July, 1987.

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APPENDIX

May 18, 1970

United Pacific Insuracne Company
Post Office Box 13,405
Kansas City, Missouri 64100

Gentlemen:

We enclosed herewith two checks in payment of the following amounts due Y & S Construction Company, Inc., and Laurel County School Building Fund.

Payment number 13; amount due	$116,666.59
less amount paid on I.R.S. levy	100,833.91
Amount due on Y & S on payment #13	$15,832.68
Payment number 14; amount due	$172,989.00

Very truly yours,

George W. Cloyd
Laurel County Treasurer
London, Kentucky 40741

GWC:wh

Enclosure

§6331. Levy and distraint

(a) Athority of Secretary or delegate.--If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary or his delegate to collect such tax (and such further sum as shall be sufficient to cover the expenses of the levy) by the levy upon all property and rights to property (except such property as is exempt under section 6334) belonging to such person or on which there is a lien provided in this chapter for the payment of such tax. Levy may be made upon the accrued salary or wages of any officer, employee, or elected official, of the United States, the District of Columbia, or any agency or instrumentality of the United States or the District of Columbia, by serving a notice of levy on the employer (as defined in section 3401 (d) of such officer, employee, or elected official. If the Secretary or his delegate makes a finding that the collection of such tax is in jeopardy, notice and demand for immediate payment of such tax may be made by the Secretary or his delegate and, upon failure or refusal to pay such tax, collection thereof by levy shall be lawful without regard to the 10-day period provided in this section.

(b) Seizure and sale of property.--The term "levy" as used in this title includes the power of distraint and seizure by any means. A levy shall extend only to property possessed and obligations existing at the time thereof. In any case in which the Secretary or his delegate may levy upon property or rights to property, he may seize and sell such property or rights to property (whether real or personal, tangible or intangible).